

Monetary Trends



An Elastic Currency

Before the establishment of the Federal Reserve System in 1913, the banking system was occasionally beset by currency shortages, particularly in times of bank panics when currency demand rose sharply. Hence, one of the key mandates in the original Federal Reserve Act was “to provide an elastic currency.”

In this day and age, concerns about providing an adequate supply of currency are much less prominent. As the Federal Reserve prepared for the recent century date change (aka Y2K), however, the issue came to the forefront once again. The concern was that the public—lacking confidence in the ability of the banking system to handle Y2K-related computer problems—would withdraw funds from their deposit accounts. Although the Fed and the banking system hold sufficient reserves of currency to accommodate higher demand over holidays and long weekends, the possibility of unusually large cash withdrawals prompted special preparations.

The Fed took several measures to address this potential problem, starting with a high-profile public relations campaign to assure the public of the preparedness of the banking system to handle potential computer problems. In anticipation of the potential for strong currency demand, the Fed also accumulated a stockpile of extra currency to have on hand. As of the beginning of October, the System had over \$200 billion in the vaults of Federal Reserve Banks and their branches.

In addition, the Fed set up additional inventory locations throughout the U.S. for rapid distribution of currency. In case banks ran unexpectedly low on available reserves, streamlined procedures for discount borrowing from the Fed also were established.

In the event, the extra currency demand at year-end was modest and presented few problems. As shown in the chart, currency in the hands of the public (as measured in the M1

aggregate) rose only about \$20 billion above trend. Although individual institutions may have encountered temporary shortfalls in available reserves, the banking system as a whole retained reserves that were more than adequate to meet demand. Much of the increase in total currency in circulation reflected banks' higher cash holdings in preparation for possible customer withdrawals. Total cash in bank vaults peaked at about \$90 billion during the week that ended January 3—about \$40 billion more than would have been expected in the absence of Y2K concerns. Both the public and the banking system lowered cash holdings sharply after the New Year, with currency aggregates returning to near trend by the end of January.

In the wake of crisis concerns that never actually developed, it is tempting to question the merit of elaborate preparations. Awareness of those preparations, however, surely contributed to public confidence in the integrity of the banks' data systems and may have prevented the emergence of anything resembling an old-fashioned bank panic. By helping to insure the banking system's Y2K readiness, the Fed successfully acted to fulfill one of its original mandates.

—Michael R. Pakko

